

Illegal deals can wreak havoc on Valley's housing market

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A wave of mortgage fraud is rippling through pockets of the Valley, inflating home values through scams called cash-back deals.

Left unchecked, cash-back deals cost homeowners and lenders millions of dollars and could erode confidence and values in Arizona's real estate market.

The fraud involves obtaining a mortgage for more than a home is worth and pocketing the extra money in cash. Homeowners stuck with overpriced mortgages may never recover the difference. Neighbors may discover home values in the area are exaggerated. And lenders end up with bad loans that, in the long run, could hurt the Arizona real estate market, the largest segment of the state economy.

While the extent of the fraud is unclear, an *Arizona Republic* investigation into these cash-back deals found organized groups of speculators have bought multiple homes this way, leaving whole neighborhoods with inflated values. Add to these the individual deals done by amateurs who hear others talk about the easy money they made from cash-back sales.

State investigators and real estate industry leaders want more enforcement and greater public awareness to stop the spread of cash-back deals before the damage mounts.

"Mortgage fraud in the Valley has become so prevalent people think it's a normal business practice," said Amy Swaney, a mortgage banker with Premier Financial Services and past president of the Arizona Mortgage Lenders Association.

Under federal law it is illegal to misrepresent the value of a home to a lender. Everyone who is a party to the deal is subject to prosecution.

Felecia Rotellini is a Notre Dame law school graduate and former assistant attorney general who is now superintendent of the Arizona Department of Financial Institutions. Her agency regulates mortgage lenders, state banks and credit unions in the state. Alarmed by what she was hearing from lenders and real estate agents, she has just pulled together state and federal regulators to form an Arizona mortgage fraud task force.

"People need to understand these cash-back deals are illegal and stop," she said. "We are going after mortgage fraud."

Cash-back deals rely on an inflated appraisal so the buyer can secure a mortgage for more than the actual sale price. In cash-back deals, usually the buyer, appraiser, a mortgage broker and real estate agent are in on the scheme and split the extra cash. The deals also can involve a notary, title person and sometimes the seller.

Beyond the money lenders lose, the most devastating effect for everyone living in the region is the inflation of home values.

The value of a house is determined in large part by the "comps," or comparable prices at which homes recently sold in a neighborhood. Buyers, sellers and real estate agents rely on comps as the benchmark for setting fair home prices. Their reliability is a foundation of the home-sale industry.

When home values are inflated:

- Owners can owe more money on their mortgage than the home is worth.
- Owners who try to sell their home may find few buyers or have to sell at a loss.
- Owners who struggle with significant debt may lose their home to foreclosure.
- Neighbors lose value on their homes.

Where multiple homes have been bought and sold this way, whole neighborhoods can suffer depressed values. Cash-back deals are just the latest form of mortgage fraud, a category of white-collar crime that has exploded across the country. In 2004, losses from all types of mortgage fraud in the U.S. were \$429 million, according to the Federal Bureau of Investigation. In 2005, as real estate and easy lending both took off, losses were \$1 billion. And 2006 losses are expected to be near another \$1 billion.

The Valley's high-velocity housing market of 2004-2005, and stiff competition among lenders who let buyers put almost nothing down on a home, created the opening for these cash-back deals. Now as the housing market has slowed, buyers find they can't resell their home for what they paid. Foreclosure notices for those struggling buyers as well as speculators who have pulled money out of homes are climbing.

"Arizona was like a housing gold rush for speculators from California, Florida and Texas a few years ago," said Detroit estate agent and fraud activist Ralph Roberts, author of the book *Flipping Houses for Dummies*. "But home prices stopped climbing, and speculators got greedy. Now the cash-back scam is going to make the savings and loan crisis of the 1980s look like a soft landing."

Cash-back scam

The cash-back deal usually starts with buyers searching for a homeowner eager to sell.

An example of how it works: A homeowner lists their house for \$300,000, but there are no offers. One day a buyer or real estate agent appears and offers \$350,000, \$50,000 above the asking price. The seller may keep the \$300,000 asking price but has to give back the extra \$50,000. Sometimes the seller is told the money is for renovations. In other cases, the seller is offered a share of the extra cash.

When everyone agrees on the deal, an appraiser delivers an inflated appraisal that is used to obtain the \$350,000 mortgage. On through the sale process, the fraud also may involve an escrow agent or mortgage broker who provides information and documents knowing the home is not worth the amount of the loan. Many cash-back sales are hidden from lenders by an addendum filed later or even marked secret.

After the papers are signed, the extra cash is divided as planned. The lender and everyone else who checks the comp on that sale believe the home has a market value of \$350,000.

Some buyers who use the cash-back scam then use short-term financing to keep their payments low and pull the scam again by selling to another accomplice. Others choose simply to walk away and deal with having a foreclosure in their credit history - a blemish that is relatively easy to erase later. Some hope to make a final sale to another buyer who is unaware of the scam, leaving that person stuck paying the mortgage on an overpriced house.

Last November, a cash-back buyer approached Brett Barry of Realty Executives at an open house in north Phoenix. The home had been reduced to \$500,000. The potential buyer said he would pay full price but wanted to raise the sales price \$40,000 or

\$50,000 and have the seller write him a check for that extra amount.

"He wanted the money under the table after the deal closed," Barry said. "He said he had a lender with an appraiser who could 'make the deal happen.'"

Barry knew the deal was bad but was obligated to present it to his clients, who also thought it was too fishy and passed.

There are other warning signs for sellers facing possible cash-back deals: Handwritten offers with details buyers don't want in the contract. A buyer's request that the home be removed from any listing service so a lender can't track the original price.

The fraud is in misrepresenting the value of the home to the lender. Buyers sign a standard loan document, Form 1003, which states: "We/I fully understand that it is a Federal crime punishable by fine or imprisonment to knowingly make false statements." And everyone involved in the deal who knew the value of the home was less than the mortgage is subject to prosecution.

For starters, mortgage brokers, real estate agents and appraisers can lose their licenses. But everyone involved in mortgage fraud including buyers and the sellers can be fined and even sent to prison.

There are many other forms of mortgage fraud, such as misrepresenting a buyer's true income, using false identification to buy or sell property, or obtaining loans for properties that don't exist.

In older cities like Detroit and Chicago, one popular scam involves buying distressed properties for little money, obtaining an inflated appraisal and immediately reselling the home to an accomplice and making off with the mortgage money.

Cash-back deals sweeping across Arizona are a newer form of fraud that flourishes in hot markets such as Phoenix with recent run-ups in home prices. Regulators are afraid cash-back mortgage fraud is becoming much more widespread around the country.

Fertile area for fraud

Metro Phoenix's booming new-home market, relatively low housing prices, steady growth and huge real estate industry drive the area's economy. Those same conditions are also a magnet for speculators and scam artists.

In 2005, loose lending standards helped the mortgage industry post record profits and struggling buyers purchase a record number of homes. Easy to obtain interest-only loans and negative amortization mortgages, along with fewer requirements on how borrowers show income, also helped speculators and scam artists snap up Valley homes. The hyper demand created by speculators played a major role in the rapid rise of Valley home values.

According to mortgage giant Freddie Mac, at least 35 percent of all homes sold in metro Phoenix during 2005 went to speculators and investors. In 2006, the number dropped, as many speculators moved on to other markets where homes were cheaper and they had a better chance of flipping them quickly for a profit. Still investors accounted for more than 20 percent of Valley home sales last year, vs. people who purchased the homes as residences.

As the hot housing market cooled in 2006, business fell for everyone in the real estate industry, including appraisers and real estate agents. Some started looking for new ways to make money. Cash-back deals became a way to keep commissions and fees coming in.

At a recent Valley real estate meeting with 1,000 agents, mortgage brokers and escrow people, a speaker asked people in the audience if they knew of any cash-back deals in the Valley. All but a handful raised their hands. Many seemed surprised when told such deals are illegal.

Cash-back deals are so common that a variety of Web sites openly promote them. Postings on the popular craigslist.com include individuals trying to sell homes by offering cash-back deals.

"Anyone in the real estate business who doesn't know these deals are illegal should get out of it," said Margie O'Campo de

Castillo of Arizona Dream Realty. "These kind of bad deals will hurt everyone in the industry and the housing market."

There are situations where cash is returned to in a home sale. For example, a real estate agent may return part of their fee to the buyer as part of the contract. But that exchange is explicitly written into the contract. Hiding cash back transactions or in any other way misrepresenting the true value of the home is illegal.

Regulators are also concerned about the role some mortgage brokers play. A mortgage broker works with a number of lenders to find loans and earns money through fees. A mortgage banker, in comparison, works for the company that provides the loan and profits through the borrower's steady flow of payments. Working for fees can lead some mortgage brokers to be more concerned about the volume of loans they handle rather than the quality or, in some cases, legality.

People are drawn to the Valley for its growth and the quick and easy money they hear other new mortgage brokers are making. Every two months, the state offers a test for people who want to become a mortgage broker. In 2005, 80 people took the test every two months. In 2006, that number rose to 100. One industry estimate shows new mortgage brokers in Arizona made 50 percent of the home loans last year. Rotellini of the Arizona Department of Financial Institutions believes the hundreds of new mortgage brokers who rushed into Phoenix include too many concerned more about making a quick buck than helping homeowners find the right loan.

"Yesterday's telemarketer is today's mortgage broker," Rotellini said.

Damaged market

The damage already has been done in areas where cash-back deals have occurred in clusters, usually in new developments where dishonest speculators can buy multiple homes. In such areas, inflated prices can affect an entire neighborhood.

Speculating in real estate is perfectly legal. Many speculators abide by the law as they ride market trends buying and selling homes. It is the speculators who try to profit by illegal means, such as cash-back deals, who can hurt home values.

The Republic investigation found neighborhoods in Gilbert, Queen Creek, Mesa, Laveen and Surprise where speculators bought groups of homes at prices significantly above asking prices and neighborhood comps - a sign regulators consider a strong indicator of cash-back deals.

Honest home buyers who later purchase in neighborhoods invaded by cash-back speculators pay higher prices based on those inflated comps.

The Republic found one new neighborhood where a group of buyers has been selling and reselling homes to each other. According to public records, members of this group paid higher than asking prices using high-interest and adjustable-rate mortgages. They own almost 25 percent of the houses in that neighborhood.

At some point, speculators who are still in the market could also be among the owners who must sell at a loss or lose their houses to foreclosure. The difference is that a speculator may find it easier to just abandon the home and take all the money they have extracted with them.

When a number of homes go into foreclosure, neighborhood home values take a heavy hit.

Tom Ruff is a real estate property record expert with Phoenix-based Information Market. At the *Republic's* request, he also analyzed the property records that suggest an ongoing cash-back scheme in the new neighborhood studied by the *Republic*. He called what he saw "a house of cards" that will soon collapse on the speculators but end up hurting other homeowners more.

The extent of the damage is uncertain because the investigation is just starting, but some believe it is Valley-wide.

"The scams have created false appreciation for the Valley's real estate market," said Diane Drain, a Phoenix real estate attorney who specializes in foreclosure cases.

Before the housing market frenzy of 2004-2005, homes in the Valley appreciated 6 to 8 percent each year. In 2004-2005, home values (based on median price for sales) jumped 50 percent. A variety of forces drove up prices, including rapid growth, aggressive outside speculators paying asking and above asking prices on the spot, and cash-back deals. Valley housing-market experts now believe home values are inflated anywhere from 10 to 40 percent. The recent drop in home values - about 5 percent in 2006 -- is part of a market correction. Ironically, cash-back deals that inflate sales prices may have cushioned the fall so far. But as those bad loans come due, they will contribute to the drop. And, in some areas, the real measure of inflated home values will be found in what homes sell for in foreclosure. Metro Phoenix home foreclosures have been steadily climbing since June of 2006 and hit a 21-month high in December. Experts believe foreclosures will continue to climb.

"Mortgage fraud makes me furious," said Swaney, the mortgage banker and past president of the Arizona Mortgage Lenders Association. "Not because I am losing business to mortgage brokers but because what it's doing to neighborhoods and to all of our home values."

Fighting fraud

Calls about cash-back deals began reaching examiners at the Department of Financial Institutions and Swaney at the Arizona Mortgage Lenders Association in late summer and fall of 2006.

The calls were from homeowners, real estate agents and lenders asking if the cash-back deal was legal. The number of calls has increased every month.

Rotellini of the Arizona Department of Financial Institutions said her agency now receives calls everyday on cash-back deals. She recently hired two consumer-complaint investigators and plans to devote the bulk of her agencies resources to investigating mortgage fraud. She admits her small staff is a minor force compared with the scale of the problem. And her agency can only go after mortgage brokers and escrow agents.

Regulation of Arizona's real estate industry is fragmented and uneven, similar to national regulation of lenders. The Arizona Department of Real Estate regulates real estate agents. The State Board of Appraisals handles appraisers. Those agencies can take away licenses and fine people and organizations but can't prosecute.

Given the scale of mortgage fraud that seems to be unfolding here, Rotellini knew all the regulatory agencies involved would have to share resources and tackle it together. So in November, Rotellini organized a mortgage fraud task force that includes the Arizona Department of Real Estate, Arizona Housing Department, FBI, Housing and Urban Development, IRS and State Board of Appraisers. They plan to share information and collaborate on cases.

Complaints and questions about mortgage fraud also have reached local police departments. They, too, will be working with the new task force.

Professional associations within the real estate industry are also worried about their members and the industry as a whole.

Don Kelly of industry trade group the National Appraisal Institute said, "In areas like Phoenix where there was a hyperescalation of home prices, there's a lot of pressure on appraisers to make deals work. But that's not their job. As the market continues to slow and foreclosures rise, fraud is likely to increase. The type of fraud you are seeing in Phoenix is going to spread to other parts of the country."

Rotellini's task force was created to pool resources on investigations and convict people of mortgage fraud. While in the Attorney General's Office, she led the investigation of Arthur Andersen, the former auditor of the now-bankrupt Baptist Foundation of Arizona. Andersen ultimately agreed to pay investors of the failed Baptist Foundation \$217million. There is also early talk of state legislation to make it easier to indict people on mortgage fraud.

Even with extra regulatory manpower and cooperation, Rotellini says it will take greater awareness among people in the real estate industry and the public to stop cash-back deals in Arizona.

"Mortgage fraud can be hard to prove because you have to show people profited and had intent," she said. "It's difficult to regulate honesty."

"It's important to get the word out and educate people that these cash-back deals are illegal, but we also have statues and can work together to find these people and take their licenses, fine them and prosecute them."